

Business and Commerce

The Canadian Chartered Accountant

FEB 13 1952

- **Observations on the Taxation of Capital Gains**
by W. F. Lougheed
- **Uniform Hospital Accounting**
by Walter W. B. Dick
- **The Application of Commercial Practices
in Determining Taxable Income**
by R. W. Manning
- **Controlling Contributions to the Manitoba
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by O. F. Thorsteinson

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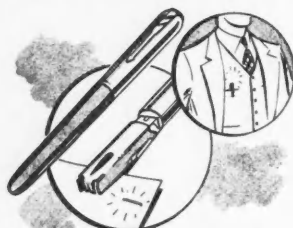
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The Canadian Chartered Accountant

VOLUME 60

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NUMBER 2

NOTES AND COMMENTS

We're Over 10,000!

THE circulation — net paid, that is — of *The Canadian Chartered Accountant* passed 10,000 with the issue preceding this one, i.e., Volume 60, No. 1, January, 1952. The figure "10,000" is a good round number which holds a certain fascination, particularly in the periodical field in Canada, though no doubt it is pretty small potatoes in countries of larger population and smaller area. We hope all our readers will be as pleased as we are with the growth of the magazine — and that all our advertisers will be suitably impressed with the increasing value they are getting for their dollar, particularly at a time when the opposite trend seems to have become chronic.

When we look at the increase in circulation over the past 20 years, the present figure of 10,000 will appear all the more impressive. In 1932, for instance, our circulation was just over 2,000. By 1942 it had reached 4,400. Thus in the past 10 years it has much more than doubled itself. In the last three years alone the increase in circulation has been just under 2,000.

Professional Brothers

ONE of the chief hall marks of a profession, as it seems to us at any rate, is the sense of brotherhood amongst its members. It is true, of course, that the members of a profession are to some

extent competitors one with the other, but they are also initiates in a mystery, to use the medieval expression. They share an interest and an outlook, they even speak a language, all of which are peculiarly theirs and often quite foreign to laymen. That is peculiarly true of the medical profession; it is very largely true of the accounting profession.

The development of the feeling of professional brotherhood takes time, of course, and the accounting profession is, as years go, still in the green leaf. Yet to one in our position of vantage it is apparent that the sense of fellowship and common interest in the profession is growing apace. Some indication of it can be seen in the monthly Professional Notes in the Magazine which show with what frequency meetings and assemblies of chartered accountants are taking place throughout the country, sometimes to hear an address on a professional subject or for social reasons, or perhaps for both. There are Chartered Accountants Clubs in a great number of cities, and Students' Societies have been organized by several Institutes. Some of these are very active indeed. All this, we think, is the outward manifestation of that process of development we have mentioned.

We ourselves were recently present at a technical session sponsored by the British Columbia Institute at Vancouver, which has now become an annual event, and were most impressed by the atmos-

phere of sharing in a common interest which was present. Our peregrinations took us to meetings of the Chartered Accountants Clubs in Edmonton and Regina, where we breathed the same atmosphere. In Winnipeg we attended a dinner meeting of the Institute at which were present many representatives of that other profession, the law, with which our own is becoming ever more closely associated. We wondered, then, if the professional brotherhood of which we speak may not be growing very large indeed.

The Examination Results

WE have before us a statistical summary of the results of the last uniform examinations and we are happy to note that the trend of successes continues in the right, namely upward, direction. At the same time, we note with regret that the hope we expressed in the November issue, that 1951 would be the examination year in which every candidate was successful, has unfortunately not been realized.

In the uniform intermediate examination, of 676 candidates who wrote 384 passed, the percentage of successes being 56.8%, which compares with 51.8% for the October 1950 examinations. Although

there were 95 fewer candidates this year than last the number who succeeded were but 11 less.

In the uniform final examination the number of candidates was 850, of whom 451 obtained passing marks and an additional 146 were awarded the right to take a supplemental examination in certain subjects. The percentage of clear passes was 53.1% which compares with a successful percentage of 51% in the 1950 final examination, and this percentage is, we believe, the highest yet obtained in the uniform final examination. This year there were 116 more candidates than last year, and 177 more successful ones.

New Brunswick's Institute takes the red ribbon for the highest percentage of successful candidates in the final examination. Of 13 herring-chokers who wrote no less than 10 succeeded, for a successful percentage of 77%. British Columbia was runner-up with 69.4% clear passes. Only two other Institutes went over the 60% mark: Nova Scotia, with 66.7% and Ontario, with 63.8%.

These results are most gratifying, except, of course, to those who must try again. To them we say, and most sincerely, "Better luck next time!"

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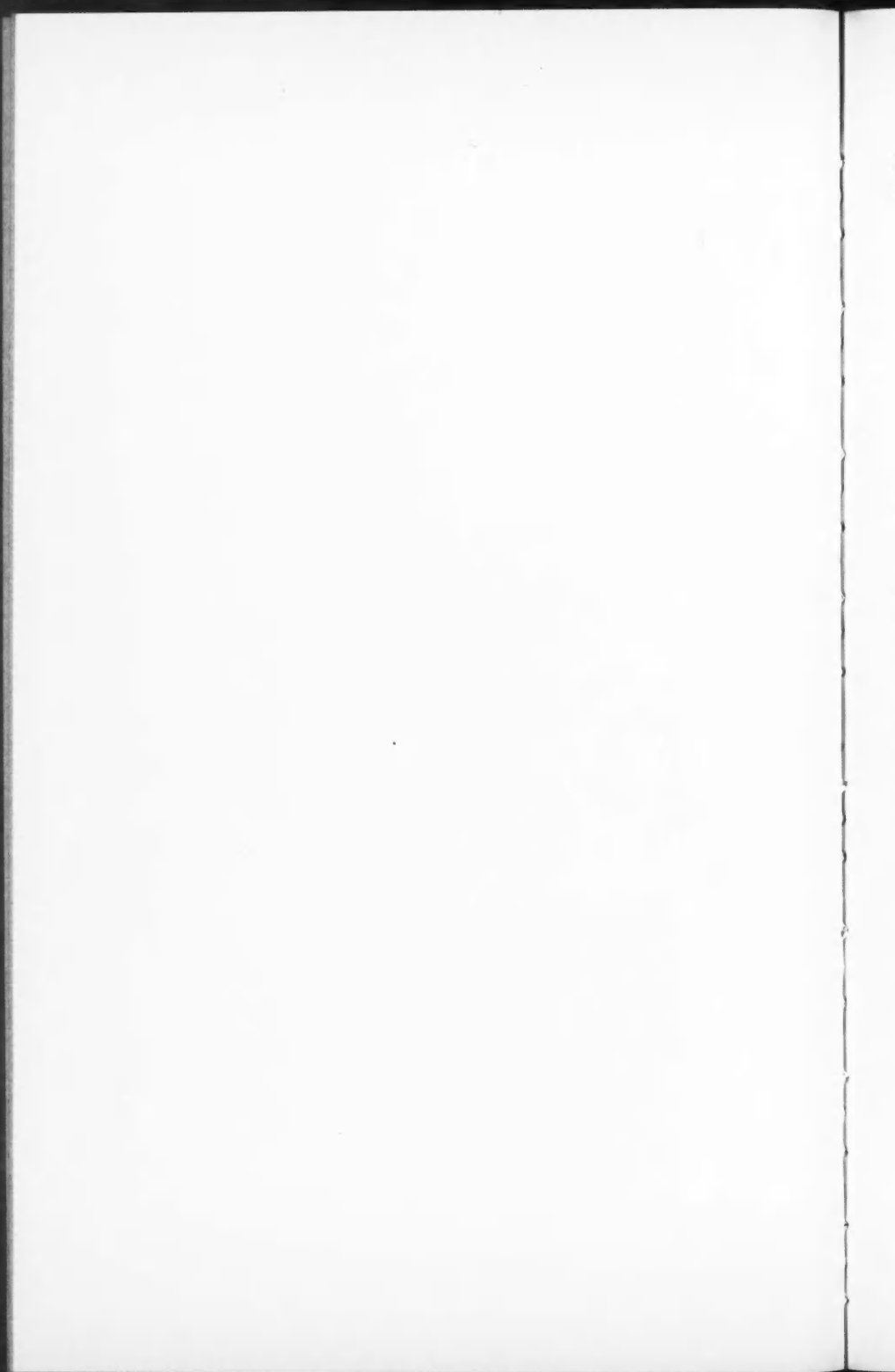
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Some Observations on The Taxation of Capital Gains

By W. F. Loughheed, M.A.

An economist's view of a problem
which is becoming of increasing interest to accountants

A TAX system ought to conform to — or at least come within reasonable limits of — well-defined and generally understandable and acceptable criteria and objectives. This belief, perhaps too simply restated, admirably serves as a background aid in the consideration of capital gains taxation. The historical literature in the field of taxation abounds with references to canons of taxation and their importance in the development of tax formulae. Since the turn of the century there have been important advances in the thinking and in experience with taxation (although possibly the areas of disagreement have widened) and in recent years there have been distinct changes in attitudes towards not only revenue-raising but also towards the purposes and objectives of government expenditure. This development perhaps has obscured the subject of tax ideals. Yet such considerations as justice, equity, universality, and ability to pay have become woven in the fabric of our fiscal philosophy, if not in administrative practice.

Expansion of Fiscal Objectives

Tax objectives (fiscal objectives) have been expanded and adjusted as a result of the development of economic and political society and without doubt have been useful in tax policy revision. Perhaps, as has been suggested from time to time, many of the old established goals of taxation are indefinite in a resurgent economy — possibly, at the margin, they are conflicting. This criticism, it is submitted, may be levelled at nearly all normal social standards. Yet, objectives are necessary in the formulation of tax policy. That there has been little public examination of the tax structure, and particularly the purposes and objectives of taxation, possibly has been due in recent years to over-riding requirements of preservation and reconversion of the economy. Perhaps in the near future the field will be opened up for review in the light of industrial and agricultural shifts that have taken place in our economy, particularly in the last decade. In considering one tax or one form of taxation it is further suggested

An address given to the Institute of Public Administration of Canada at its Third Annual Conference, Winnipeg, September 6, 1951. Opinions expressed here are personal and do not necessarily reflect those of the institution with which the author is connected.

that no tax stands complete and alone with regard to what are viewed as general canons of taxation. In this vein it might be added that the tax system cannot and should not be judged upon (or based upon) any one canon — particularly fiscal adequacy. Hence only limited reference is made to tax ideals in the present discussion of capital gains; a wider examination is invited.

Meaning of "Capital Gain"

In the general field of income analysis and the taxation of income, the existence of gains and losses arising from transactions in assets or evidences thereof provides one of the most controversial issues in this field.

To the layman the term "capital gains" suggests a "profit" which arises as a result of a transaction or series of transactions — the disposition of capital assets. If a simple illustration will suffice for the moment, then the purchase of securities for cash and their subsequent sale for a price greater than initially paid results in a "capital gain". If the subsequent selling price is less than the initial cost there arises what is termed a "capital loss". Capital gains and losses for tax purposes focus principally on the sale of securities but they appear also in the sale of real estate or other property.

The origin of the term "capital gain" is obscure, although in its application for tax purposes it is suggested that, in its initial usage, it is peculiar to the United States. In Great Britain such gains are, except for the professional operator, considered as an "accretion of capital" or more popularly "casual profits", and as such are excluded from the tax base. Other European countries from time to time have attempted with varying difficulty to distinguish, arbitrarily in most cases, between capital and income for the purpose of computing or adjusting the tax base.

Much of the literature suggests that the taxation of capital gains falls within the general field of income taxation;¹ and the taxation of "income" involves a reasonably acceptable definition of the term. Also the schedule of rates applied to the taxable base has an important bearing on the objectives to be achieved. Hence as a starting point it seems desirable to review briefly and to bring into focus issues centering on interpretation and terminology.

The "Income" Concept

The term "income" has been exposed to lengthy discussion and reinterpretation by lawyers, accountants, and economists. For taxation purposes the tax authorities (and in some cases the Courts) have become the interpreters. Particularly in Canada and in Great Britain the interpretation by the Courts of the term "income" for tax purposes has become the *sine qua non* of inclusion or exclusion of profits in the calculation of net taxable income.

¹ In this connection the 1938 report of the Committee on Taxation of Capital Gains of the National Tax Association is noteworthy: "The Committee is a unit in believing capital gains are income. This belief arises not from theoretical considerations but because the layman thinks they are. The enhancement of position which to the layman is the determinant of income arises not only from interest, rent and salaries but also from selling property at more than cost."

In the *Eisner v. Macomber* case (252 U.S. 189) Mr. Justice Holmes noted: . . . "the word 'income' in the Sixteenth Amendment should be read in a sense most obvious to the common understanding at the time of its adoption . . . For it was for public adoption that it was proposed . . . The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest."

One concept of income is that of a monetary value of a flow of utilities to an individual within a given time. Implicit in this concept is psychic income — income as represented by the enjoyment derived from goods consumed and services received. This definition, for Irving Fisher, led to the view that the income tax should be applied to that part devoted to spending and the exemption of that part which was invested or saved — on the ground that double taxation should be avoided: "The saved part of income thenceforth pays income tax on the interest or profit which it brings notwithstanding that it has already been taxed on the principal."²

Another view of income is that it is a net accretion to a person's economic power between two points of time. According to this concept it is held that income could and should include increases in value whether realized or not as well as receipts of gifts and legacies. In arriving at net accretion, personal and/or business expenses doubtless would be deducted.³

A third view of income is recurrent consumable receipts.⁴ This interpretation would appear to be broader than the flow of utilities concept of Irving Fisher, yet narrower in many ways than the net accretion approach. It would include recurrent items such as wages, salaries, interest, rent, dividends, royalties, and net business income. Receipt

W. F. Lougheed, M.A. was born in Toronto and received his education at the University of Toronto Schools, McMaster University and the University of Chicago. He began his teaching at Wayne University, Detroit, Mich., where he was an Instructor in Economics. From there he went to Dalhousie University as Research Professor, and from Dalhousie to the University of Manitoba as Professor of Commerce and Head of the Faculty of Commerce at that University. During the period 1940-44 while in Manitoba he worked with the Economics Division of the War-time Prices & Trade Board, and was also Adviser on Industrial Relations to the Provincial Government of Manitoba. He joined the Canadian Bank of Commerce in 1944 as Economist to the Bank, and in 1945 served also as special lecturer in Finance at McMaster University.

of money payments would be viewed as income whether or not it was converted into goods or services. Unlike the second concept recurrent receipts would, in the main, exclude capital gains, gifts, and legacies.

Over the years taxation of income has tended to combine or to utilize in some combination the concepts of "net accretion" and "recurrent receipts". This has led particularly in the United States (and in some instances in Canada) to a variety of approaches to capital gains taxation. Brief reference only can be made to the question of definition, yet the divergent views noted indicate a continuing area of disagreement which has resulted in contradictory views concerning the calculation of the tax base.⁵

² See particularly Irving Fisher: "Income in Theory and Income Taxation in Practice", *Econometrica*, January 1937. The double tax aspect was emphasized by J. S. Mill, *Principles of Economics*, Book V, Chap. II, Sec. 4.

³ R. M. Haig is representative of the group holding this view. See *The Federal Income Tax*, p. 27 *et seq.* (Columbia University Press, 1921.)

⁴ See particularly Carl Plehn: "Income as Recurrent Consumable Receipts" *American Economic Review*, Vol. XIV, p. 2 *et seq.*

⁵ Limits imposed by this paper preclude some discussion of whether the income tax should

In terms of the day to day task of administration we find ourselves working with methods designed to give results approximating personal income.

Indeed every income tax is, and perhaps must be, based largely on presumptions. With respect to business enterprise, tax laws and administrative regulations usually take over conventional accounting rules. More generally the government assumes the task of proving concealment or omission of positive items and places on the taxpayer the burden of proof as to the proper deductions. The tax laws do not really define income but merely set up rules as to what must be included and what may be deducted; and such rules by no means define income because they are neither exhaustive nor logically coherent. That rules of this kind work out at all well is due to the co-operation of tax-payers, the paucity of ingenious lies, and to the availability of checks in market places, in information derived from third parties and in the mass of business records and accounts.⁶

Influences on Canadian Viewpoint

It would be a fair appreciation of the taxation of income in Canada to suggest that the greatest influence in procedure

and interpretation has come from the administrative and legislative procedures in Great Britain. When the Canadian *Income War Tax Act* was first enacted it would appear from comparison that the definition of income was borrowed in a large measure from the *Revenue Act* of the United States; it bears little resemblance to the English Act. Yet it may be suggested, fortuitously perhaps, that the legislators in enacting the tax in 1917 intended that the word "income" be viewed in the British legal sense. As one Canadian legal authority observed: "That our Supreme Court has followed the English distinction between "income" and "capital" needs no comment. In fact it is rare that our Courts attempt to define the word "income" as related to the particular facts before them, but they usually resolve the problem by quoting the appropriate English case."⁷

One of our difficulties centres on the fact that the conception of income, in the legal sense, evolved from the emphasis in earlier centuries on agricultural income and administrative practices arising therefrom. (It is possible that "realization" and "separation" criteria owe

or should not be viewed as a personal tax or whether tax practice with regard to income involves *ad rem* implications. This is debatable although there is some evidence to suggest that there are *ad rem* anomalies present. It is the generally accepted opinion, at least among economists, that the income tax is a tax upon persons according to their respective incomes, not a tax upon income *per se*, and "subject to the requirement of adherence to simple general rules the objective of policy must be fairness among persons *not* fairness among kinds of receipts (whatever that might be construed to mean) . . . for equity in personal taxation with exemptions and progressive rates requires that persons of very different income circumstances should pay very different additional taxes by virtue of the same particular receipts." (Henry Simons: *Per-*

sonal Income Taxation, University of Chicago Press, p. 128, also p. 134.) In interesting contrast is the recent observation of Lord Macnaghten in *London County Council v. Attorney General*, "Income tax, if I may be pardoned for saying so, is a tax on income. It is not meant to be a tax on anything else." (Mary S. Murphy: "Tax Reform Proposals in Great Britain", *Tax Policy*, Vol. XVIII, Nos. 7 and 8, July 1951. Tax Institute, Princeton, N.J.)

⁶ See Henry Simons: *Personal Income Taxation*. (Chicago, University of Chicago Press) Chap. I and II.

⁷ R. de Wolfe MacKay, K.C.: "Definition of the term 'Income'." Address to the Tax Section, The Canadian Bar Association, Washington, D.C., Sept. 1950. See particularly the case of *Morris Realty Co. v. Brown*, 1932, S.C.R. 187.

much of their genesis to this.)⁸ Also there was a feature in English and Continental practice of establishing (legally speaking) a line of heirs so that some legal concept of income became a necessity. In the legal literature of the period the definition of capital and income centred on the existence of entailed landed properties and the yield therefrom, ignoring changes in values or accretions to capital, for income determining purposes. Hence the position of the British Courts has been to exclude "casual profits" from the determination of income for tax purposes. The degree of influence — present and future — on Canadian tax procedure is, however, difficult to appraise.⁹

The IWTA: Income Defined

In *The Income War Tax Act* income was defined in a positive manner. In s. 3(1) income was defined as "the annual net profit or gain or gratuity, whether ascertained and capable of computation as being wages, salary, or other fixed amount, or unascertained as being fees or emoluments, or as being profits from a trade or commercial or financial or other business or calling, directly or indirectly received by a person from any office or employment, or from any profession or calling, or from any trade, manufacture or business, as the case may be; and shall include the interest, dividends or profits directly or indirectly received from money at interest upon any security or without security, or from stocks, or from any other investment,

and whether such gains or profits are divided or distributed or not, and also the annual profit or gain from any other source: including the income from but not the value of property acquired by gift, bequest, devise or descent; and including the income from but not the proceeds of life insurance policies paid upon the death of the person insured, or payments made or credited to the insured on life insurance endowment or annuity contracts upon the maturity of the term mentioned in the contract or upon the surrender of the contract."

It might be noted that the phrase "and also the annual net profit or gain from any other source" could have very well been used as a basis for taxing capital gains.

The ITA: Income Undefined

In 1948 the 1917 Act was redrafted and replaced with the *Income Tax Act*. In this Act, which came into effect on January 1, 1949, there is no definition of income. Sources of income are referred to and methods of computing income are prescribed, but the problem of determining the basic concept of income with the scheme of the Act is now to be referred to the Courts exclusively — apparently, according to one authority, "untrammelled by prior jurisprudence".¹⁰

A close approximation to a definition of income is in the interpretative section (s. 127(1)) which reads as follows:

Income from a source. — A taxpayer's income from a business, employment, property or other source of income or

⁸ E. R. A. Seligman: "Are Stock Dividends Income?", *American Economic Review*, 1919, pp. 517-536. See also R. H. Montgomery, *Income Tax Procedure*, p. 590 (Ronald Press, 1926); *Eisner v. Macomber*, (252 U.S. 189) and Eustace Seligman, "Implications and Effects of the Stock Dividend Decision", *Columbia Law Review*, XXI, 313-33.

⁹ In 1950 a Royal Commission on the Taxa-

tion of Profits and Income was set up to enquire into the present system of taxation of profits and income. Whether the English income tax will continue to be "an object of deep admiration among Americans who have large capital gains" will be of interest. See Henry Simons, *Federal Tax Reform*, 1950, University of Chicago Press, p. 71.

¹⁰ de Wolfe MacKay, *Op. Cit.*

from sources in a particular place means the taxpayer's income computed in accordance with this Act on the assumption that he had during the taxation year no income except from that source or those sources of income and was entitled to no deductions except those related to that source or those sources.

The word "income" as used in the *Income Tax Act* must be construed in this context, and there are certain indications throughout the Act that the word "income" as used was not intended to include capital gains. For example, s. 7 deals with payments being in part payments of an income nature and in part payments of a capital nature, and including in taxable income only that part which is of an income nature. This, and other sections of the present Act (particularly s. 6(j), s. 11(1) and s. (12) indicate that the intention behind the legislation is to exclude capital gains from the concept of taxable income, but, as already inferred, one must turn to the Courts to discover the difference between income and capital gains. Even here "not an infallible criterion emerges from a case since each of them turns upon its own facts; but the decisions are useful as illustrations and as affording indications of the kind of considerations which may relevantly be borne in mind in approaching the problem of discriminating between income disbursement and capital disbursement."¹¹

The Position of the Courts

Having regard for the fact that when the matter of capital *versus* income came up under the *Income War Tax Act* British decisions were followed, interpretation of the recently revised Act appears to raise some questions. Of current interest is whether or not the Canadian Courts are likely to interpret the word

"income" more broadly than in the past — possibly borrowing from American experience.

Since the new Act came into effect there has been considerable agitation with respect to amendment. The basis for this agitation centres on an Exchequer Court decision in *McDonough v. The Minister of National Revenue*¹² and the decision of the Income Tax Appeal Board in *Brown v. The Minister of National Revenue*.¹³ It has been suggested that these decisions were arrived at by applying the tests laid down in *California Copper Syndicate v. Harris*. In this case Lord Justice Clerk stated, "It has become a well-settled principle in dealing with questions of assessment of income tax that where the owner of an ordinary investment chooses to realize it and obtains a greater price for it than he originally acquired it for, the enhanced price is not profit assessable to income tax, but it is equally well established that enhanced values obtained from realizations or conversion of securities may be so assessable when what is done is not merely a realization or change of investment but an act done in what is truly the carrying on or carrying out of business What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being — is the sum of gain that has been made a mere enhancement of value by realizing a security or is it a gain made in an operation of business in carrying out a scheme of profit making."¹⁴ In commenting on current practice, particularly with reference to the *California Copper* case, it is suggested by one authority that "the test of taxability is the presence of an intention to make a profit. If

¹¹ H. A. W. Plaxton: *The Law Relating to Income Taxes in Canada*, p. 30 (Carswells, Toronto.)

¹² 1949 (C.T.C.) 213.

¹³ 1 T.A.B.C. 461.

¹⁴ (1904) 5 TC 159, 165 and 6.

motivation is to be the test of distinction between a capital gain and income the capital gain is likely to be a rare occurrence."¹⁵

Mr. Abbott's Assurance

The present position of the Government with respect to the taxation of capital gains is worthy of note. In the budget speech of March 1950 the Minister of Finance stated:

Perhaps I might also take this opportunity, in view of recent public interest in the question, to assure the house that it is not the policy of the Government to tax capital gains. Under any income tax law there is always a very difficult problem in drawing a line between gains which are profits from carrying on a trade or business and those which are not. To my knowledge no tax legislation has ever been passed in any country that has removed all doubts on this score. In England, where our basis of income tax had its origin, the matter has been settled almost entirely by the courts, taking into account the facts in each individual case. Much as I would like to introduce greater certainty, I do not believe that it can be done satisfactorily by legislation. We now have a readily available Income Tax Appeal Board that has been set up to determine questions of this sort."¹⁶

Principle of Imposition

During the early period of World War II the Minister of Finance in presenting his "pay as you go" policy stated that "in imposing the new burdens . . . we shall insist on the principle of *equality of sacrifice on the basis of ability to pay*".¹⁷ These terms invite examination (more than can be given in a short paper) in the consideration of tax policy.

In most of the literature on the subject of justice in taxation the term "sacrifice" arises. But what is implicit in the term has given rise to a number of opinions, certainly not leading to unanimity. Equal sacrifice to J. S. Mill centred on the distribution of the tax burden, i.e., the rates should be arranged in such a way that the same total sacrifice is imposed upon every individual.¹⁸ F. Y. Edgeworth took the view that (income) tax rates should be constructed to achieve minimum sacrifice—equimarginal sacrifice among individuals.¹⁹ In application this would involve equating among differently situated taxpayers the tax burden at the margin. Least aggregate sacrifice for A. C. Pigou "is an ultimate principle of taxation" and here too the marginal calculus is used to achieve equal sacrifice at the margin.²⁰

Income utility is implied and expressed in these cases. It is conceded that some relationship between income and its utility exists, and, further, one might reasonably assume a downward sloping curve, the integral of the function, conceivably measuring total utility. But as to the shape of the curve (its equation) the question remains open despite the reams of literature available.²¹ However, the acceptability in principle of progressive rates in part, at least, is traceable to this type of analysis. There still remains for consideration whether periodic changes (increases) in the rate structure affects the previously established balance between taxpayers — whether or not marginal utility of income is construed, administratively, to be constant.

¹⁸ J. S. Mill: *Principles of Economics*, Book V, Chap. II, s. 2, (Longmans Green).

¹⁹ F. Y. Edgeworth: *Papers Relating to Political Economy*, Vol. II, p. 116. (London, MacMillan Co.)

²⁰ A. C. Pigou: *Public Finance*, p. 61 *et seq.* (London, MacMillan Co.)

²¹ Depending on the shape of the income utility curve (its arc elasticity) "equal

¹⁵ J. R. Petrie: *The Taxation of Corporate Income in Canada* (to be published by the Canadian Tax Foundation).

¹⁶ House of Commons Debates, March 28, 1950, p. 1217.

¹⁷ House of Commons Debates, September 12, 1939.

Of more particular current interest in considering the rate structure is the question of whether taxation should be confined to the purpose of raising sufficient revenue or whether taxation should be employed for the purpose of bringing about a different distribution of wealth from that which would result from the working of free competition within the framework of the present social order. "The popularity of progressive taxation in recent years" — noted Robert M. Haig — "is doubtless traceable in no small part to the opportunity it offers in a democratic state to place added burdens upon the group which while economically strong is often politically weak."²²

In the same connection, although in a somewhat lighter vein, the question is dealt with by Stephen Leacock thus: "Pupkin knew just what the Judge thought of riches and luxuries. How often had he heard the Judge pass sentences of life imprisonment on Pierpont Morgan and Mr. Rockefeller. How often had he heard him say that any man who received more than \$3,000 a year (that was the judicial salary in the Missinaba District) was a mere robber unfit to shake the hand of an honest man . . . He (the Judge) was not so bitter

perhaps as Mr. Muddleson, the principal of Mariposa High School, who said that any man who received more than \$2,100 was a public enemy."²³

Perhaps depressions and wars (and universal suffrage) have served to move taxation from the prime purpose of raising revenue to a much broader concept of mitigating gross inequalities of wealth. Income taxation, particularly, is conceived by many as an effective instrument of economic control. Even so, one must consider on the one hand the issues inherent in such terms as "discrimination", "inequity", and "social justice", and, on the other, considerations attendant upon the maintenance of a dynamic capitalistic system and, above all, the savings-investment process. Certainly, private capital expansion is more necessary than ever in an economy which has adopted the maintenance of "full employment" as a major objective of economic policy.

Having regard for the trend in current discussions regarding the taxation of capital gains, it would appear desirable to reach some working basis of agreement on issues inherent not only in terminology but also in the philosophical background of the tax structure before changes are made.

sacrifice" could result in regressive taxation and in varying degrees of mild progressiveness. See A. C. Pigou, *op. cit.* p. 107-117.

A rather interesting (and irresistible) observation on "sacrifice" is offered by Harry Gunnison Brown: "But why should we want taxes levied so as to make the 'sacrifice' of different taxpayers precisely equal? Is the word 'equal' in this connection anything more than a euphemism? Why not claim that the amount contributed by different taxpayers should be 'equal'? Or that each should contribute an 'equal' per cent? Is there any reason from the point of view of logic, ethics or the welfare of the social group why the thing to be made 'equal' in the case of different taxpayers should be their 'sacrifice'? Indeed, why not make the 'sacrifice' very unequal

in order that the magic word 'equal' may be applied to the net income remaining to taxpayers after tax contributions are subtracted? Is there, in short, any really convincing argument for having the word 'equal' apply to sacrifice rather than to amount of tax contribution or per cent of income taken or amount of income left for individual spending, except that some economists intuitively feel that way about it. Are not some of our mentors, in fact, giving us a mumbo-jumbo economics?" H. G. Brown: *Fiscal Policy, Taxation and Free Enterprise*, Lucas Brothers, Columbia, Mo. 1946, p. 65-66.

²² *Encyclopedia of the Social Sciences*, MacMillan Co. 1944, Vol. XIV, p. 539.

²³ Stephen Leacock: *Sunshine Sketches of a Little Town*, MacLelland & Stewart, p. 186.

Difficulties in Determining Question

Brief reference was made at the outset to the term "capital gains". A simple example was given of gain accruing to an individual in the sale of a security. That there is in reality a variety of capital gains complicates the task of their inclusion in the income tax base or of defining income to eliminate avoidance. In the light of the trend in the rate of interest, the rearrangement of an investment portfolio presents a case in point. Take, for example, the sale of securities. In this case bonds bearing a relatively high interest rate are selling at a lower yield basis. The sale would yield a nominal gain in principal. In the revised portfolio (with a change in the risk factor) the selection of securities well might yield a lower return to the investor. Does this transaction represent a gain? Does this indicate "ability to pay"? Alternately, revision of a portfolio could result in the maintenance of over-all yield, yet a capital loss could be effected which (depending on the Tax Act) could be deductible.

Changes in price levels create circumstances where a gain might be viewed as ephemeral rather than real. True, indeed, holders of equity securities and properties tend to gain relative to other groups during price rises. But consider the case of houses which had been purchased prior to the recent upward inflationary trend. Sales in recent years in many instances have reflected substantial gains, but in buying another house the gain more often than not was offset. Is there a capital gain in the transaction or, for that matter, increased "ability to pay"?

There is a tendency to concentrate attention on the individual in dealing with capital gains, yet corporations likewise are involved in this field of taxation. A brief reference to this will suffice. In

the American field it is my understanding that corporations in the disposal of capital assets no longer useful in the business well may encounter the possibility of capital gains taxation. It has been suggested that this is not particularly serious except for securities, for a corporation having assets in its trade or business would be very unlikely to sell them at a profit because cost minus depreciation is seldom above the market value at the time the corporation disposes of them. Yet with regard to the trend in real property transactions this does not necessarily hold.

Of more than passing interest is the "realization procedure" where an individual by diversifying his portfolio could show little "taxable income" over a period of years. In Henry Simons words:—"in an irresistible phrasing — to have and to hold all faithful (appreciated) investments till death (do us part) and to divorce opportunely all unfaithful (depreciated) shares."²⁴

Is Precise Definition Desirable?

These few examples suffice to raise the question as to whether or not a formal "spelling out" is a desirable approach to the problem. We are faced with the fact already noted above that the present *Income Tax Act* does not define income. If income is viewed as gain — a net accretion to one's command over economic resources — between two points of time, then net gain reflects additional tax-paying capacity and logically must be included in income. On the other hand, if receipts to the individual (or the corporation) must be recurrent (and realized) then certainly a large area of gains is excluded from the definition of income. If we were to

²⁴ Henry Simons, *Federal Tax Reform*, University of Chicago Press 1950, p. 62; H. M. Groves refers to this question in an article entitled "Yachts without Income".

go along with the group represented by Irving Fisher that saved income should not be taxed, then capital gains must be excluded. If we rely on the British interpretation of gains, that is, the *vocation-al* as distinct from *avocational* approach, as casual profit then their exclusion from the income base must be subject to arbitrary interpretation. Yet it is of interest that income for tax purposes can arise in one case and not in another, depending on the number of transactions involved. Here arbitrary decision transcends the *certainty* criterion of Adam Smith which no paper on taxation could overlook at some stage. At the moment we face an apparent lack of consistency in taxing or not taxing capital gains depending on administrative legal interpretation.

Should Capital Gains be Taxable?

Whether gains should be taxable apart from the income tax is another issue concerning which there is a variety of opinions. Citing from American experience, it is noteworthy that recognition has been given in varying ways over the years to the peculiar character of gains (or losses) in contrast with other forms of income. An historical survey of changes and amendments indicates specific limitations on the deductions of losses, a flat and relatively low rate for certain classes of taxpayers, fractional taxation, and time periods and varying tax rates attendant upon "realization".²⁵ One inference that can be drawn from American experience is that while a large body of opinion views cash gains as income, there is the implication that gains do not have the revenue capacity for tax purposes of other income. Capital losses appear in an even more anomalous light

for they have been deductible in only limited amounts from other income. Only between 1918-1924 were they fully deductible.

As to whether the tax is a useful addition to the tax structure, the business view was summed up effectively in 1942 by the president of the New York Stock Exchange.²⁶ After conceding that both the proponents and opponents of the tax agreed that revenue-raising was paramount, he took the view that the tax defeated its own purpose. In his testimony he stated, in part: "It seems to me there are but two reasons why people invest their capital. Either they invest to obtain income by way of rents, dividends, or interest or they invest with the hope that they may sell the investment at a profit. Unless taxpayers are willing to buy and sell capital assets there is no possible way of deriving revenue from a capital gains tax . . . The effects of the capital gains tax extend far beyond the security market. It hits every land owner and every business man who makes a capital investment of any kind. Its chilling effect is as great on the price of farm lands and other real estate as it is on securities listed on the New York Stock Exchange."

Effect of Tax on Action

Two additional questions regarding capital gains taxation invite brief consideration: namely, the effects of a tax with regard to fluctuations in asset prices, which is the question of stability or instability; and the question of the effects on venture capital and economic growth.

As a prefatory note to these questions, it is suggested that little statistical evidence is readily available on which to

²⁵ See Anita Wells: "Legislative History of Treatment of Capital Gains under the Federal Income Tax 1913-1948", *National Tax Journal* (March 1949), Vol. II, No. 1, p. 12, *et seq.*

²⁶ Testimony of Emil Schram during the Hearings on Revenue Revision by the U.S. House Committee on Ways and Means. Reprinted in H. M. Groves: *Viewpoints on Public Finance*, 1947, Henry Holt, N.Y. pp. 154-157.

base a considered view. When the rates of the American tax varied depending on the length of time the assets were held before realization, the view has been put forward that in some cases some assets were held for an undue length of time on the ground that relatively high short term tax rates prevented some sales which otherwise might have occurred. To some writers (though it is by no means a unanimous view) a capital gains tax aggravates price rises and price falls. It is suggested that under conditions of rising prices — particularly when profit-taking predominates — the tax tends to encourage even higher prices. Conversely, in a falling market the tax tends to encourage lower prices than would otherwise exist.²⁷ However, it is difficult to say categorically whether or not some reduction in the exchange of securities would be socially a "bad thing". It often is commented that floating ownership in United States corporations results from trading in securities purely for appreciation.

Whether the supply of venture capital is discouraged is a field open to analysis and verification; it would be difficult *a priori* to make a case for encouragement. The view has been expressed that the distribution of new issues may have been hampered in the United States by capital gains taxation particularly under the pre-1948 tax arrangements. Under the recently revised tax legislation the tax distinction between short and long run gains might be offset somewhat by the taxation of family units. No such qualifications are introduced by the business community. In this connection Mr. Emil Schram stated: "Time and again I have heard people say, 'I know that this is a sound venture and I know that it needs

equity money but I won't go into it because if it succeeds I will have to give most of my gain to the Government, while if it fails I will have to bear the loss myself' . . . I think it is demonstrable that a high capital gains tax has been an important factor in discouraging people from making capital investments."²⁸

Penal Effect of Taxing Capital Gains

It already has been expressed that taxation now is being used for revenue-raising and as an instrument of social and/or fiscal policy. Both of these aspects enter into consideration in dealing with the efficacy of capital gains taxation. Since revenue from capital gains taxation depends upon the operation (in the main, voluntary) of the people it would be difficult in the extreme to budget for additional revenue with any degree of accuracy. Moreover, windfall revenues and expenditures can lead to political and administrative difficulties particularly under inflationary conditions, and perhaps to financial difficulties in the long run.

Since many gains are irregular, are often casual and well may be "paper gains" due to a "fluctuating dollar" and in the absence of some averaging technique for tax purposes — say a five year period — there could be a severe penalty imposed on such gain if taxed at existing progressive rates.

If gains were to be treated as ordinary income, a strong case could be made that capital losses likewise should be deductible in keeping with "equity and ability to pay". If losses are only to be deducted to the extent of gains then there is moreover a case for treating capital gains separately from income.

²⁷ See particularly, H. M. Somers: *Public Finance and National Income*, The Blakiston Company, Philadelphia, p. 204, and the article by Jacob Viner, "Taxation and

Changes in Price Levels", *Journal of Political Economy*, August 1923, Vol. 31, No. 4.

²⁸ Quoted in *Viewpoints on Public Finance*, see ²⁶.

Since administrative and legislative experience with capital gains, particularly in the United States, suggests the view that there is a difference between capital gains and income, it may be more practical (though not necessarily correct) to separate the two.

Present Case Law Inappropriate

In the practical application in the Canadian field, it would appear necessary to re-examine and possibly to disregard much of the case law in existence. Even more important, it would be eminently desirable to re-examine the whole tax structure with special reference to the taxation of undistributed corporate profits. This could have a great bearing on the necessity of taxing or not taxing capital gains. Then, too, the question of fluctuating or stable revenues for federal disposal is open for discussion, particularly in the light of the trend towards rigidity in a large segment of expenditures.

If we are to take seriously the treatment of similarly circumstanced people similarly, and if we are to continue the program of "reducing inequalities in income", then complete exemption of capital gains conflicts with considerations of equity. However, it must be noted that what might have been construed a decade or so ago as a real capital gain derived from reinvestment of income well may be in the inflationary economy of today the result of changes in the price level and changes in interest rates. "Gains" under these circumstances have an unreal element and perhaps it might

be suggested that the case is less strong under these circumstances than in more stable periods.²⁰

The Administrative Problem

I have not considered in any detail the technical problems inherent in administration. There would be both the "house-keeping problem" — the problem of securing the necessary information and of processing it for tax purposes — and there could also arise the problem of divided jurisdiction in the application of a capital gains tax. With regard to the latter, those most familiar with the field will appreciate the anomalies and difficulties in administering inheritance and estate taxes, the administrative conflicts inherent in the *situs* and *domicile* issue and the possibility of different taxing authorities defining income (and/or capital gains) differently for tax purposes. A study of the difficulties inherent in these areas of enquiry could indeed be useful and in fact necessary at some stage.

Certainty Essential

Throughout the literature of taxation the "cardinal virtues" of justice and equality receive their due measure of comment. It would seem equally significant to emphasize *certainty*. It is not too much to suggest that in our tax structure a person engaging in a transaction should know where he stands tax-wise. While, as already noted, there appears a "gray zone" in the present administration of our income tax, this zone may be narrowed by business men as well

²⁰ On this point an interesting study was recently released — Gilbert Jackson & Associates, Toronto, Memorandum June 1951: "Canada: Comparison between Changes in the Cost of Living and Changes in the Prices of Common Stocks since 1939." In dealing with the question of gains under an unstable price level the memorandum states: "In other words, Can-

adian investors in common stocks — unless the price of their securities rose by more than 79% — not only gained nothing at all in the stock market during this period, but actually lost part of what they formerly possessed. That is to say, they made no real capital gains at all, but suffered a net impoverishment."

as by government. At the moment I think it would be unwise, if not extremely difficult, to apply piecemeal additional taxes even though the demand for revenue is becoming insatiable. What is needed far more is a thorough revision of the tax structure, the dictum of *old taxes being good taxes* notwithstanding.

The plea of Luther Gulick, president of the American Institute of Public Administration, writing in *Income Tax Administration* is a fitting epilogue:

At this point in our history there are two further tax principles which need stressing, one an old canon, and the other a new goal. The old canon takes us straight back to Adam Smith. We des-

perately need to re-examine and reform our total tax system in all its parts to make certain that it is certain, convenient, economic, and enforceable. Unless we do so, all our other goals will be but partially attained. Second, we need to define, study scientifically, and enforce a new tax goal, born of our generation and of our democratic system with a federal government and municipal home rule. That goal is tax conformity with our political institutions, so that taxation will contribute to, rather than thwart, the balanced operation of our democracy.³⁰

³⁰ Luther Gulick: "Basic Goals of Tax Administration", *Income Tax Administration*, 1948, New York, Tax Institute, p. 17.

THE SIXTH INTERNATIONAL CONGRESS ON ACCOUNTING 1952

The Sixth International Congress on Accounting, 1952, which is to be held in London from June 16 to 20 will now take place in the Royal Festival Hall, South Bank, not in the Royal Horticultural Halls as previously announced.

Brigadier S. O. Jones, O.B.E., M.C., has been appointed chief executive officer in succession to the late Major-General E. C. Hayes, C.B., whose sudden death occurred last August.

Uniform Hospital Accounting

By Walter W. B. Dick, B.Com., C.A.

There are many reasons why uniform accounting for hospitals is being urged more and more

THE increasing financial importance of the general hospital in the Canadian economy has given rise to a growing need for sound and dependable accounting principles and practices as basic aids to good administration.

The sharp rise of interest in the finances of the hospital is due to the fundamental changes which are taking place in the relationship of this institution to society. Modern medical developments have been such that the hospital is no longer considered as something which should be left entirely to charity. In their early years, the hospitals were looked upon as charitable organizations; consequently very little thought was given to care in accounting for their activities. The current appreciation of accounting for the modern community hospital is apparent after an appraisal of its economic status and its place in the affairs of the community.

Hospital Economics

Today, a general hospital serving a community with a population of 50,000 would probably have a rated bed capacity of 225 beds. For this typical hospital the ratio of beds to population is 4.5 beds per 1,000 of population. Such a bed ratio is 2.5 beds per 1,000 of popu-

lation short of the 7 beds considered desirable for adequate hospital care. (If the last mentioned ratio were to be applied, the figures presented here for plant, operation, and personnel would require proportional enlargement.) The land, building, and equipment for a 225 bed hospital would require an investment of capital amounting to approximately \$3,500,000. The annual operating expenses of this institution would be about \$1,200,000. This amount would consist of the following general classes of expenses:

Salaries and wages (55%)	660,000
Supplies, including food, medical, and surgical items (40%)	480,000
Repairs, replacements, depreciation, interest, and other expenses (5%)	60,000
Total operating expenses	<u>\$1,200,000</u>

The professional, administrative, and maintenance staff for the general hospital referred to above would be close to 340 persons. Such economic data for a community of moderate size indicates very clearly that the hospital is big business.

It is therefore evident that hospital

administrative officers must have the best management tools available in present day accounting to control and direct efficiently an institution of the economic scope referred to here.

Why Uniform Accounting?

Hospital association's third party agencies (hospitalization plans and various government bureaux), and provincial and federal health departments, realizing the advantages of uniform hospital accounting have actively sponsored its development.

Uniform accounting provides, in addition to standard methods and procedures of accounting, data which may be used in making comparisons. While internal comparisons are useful, external comparisons are "chock-full" of management material. Where comparisons with uniform data are made between like institutions efficiency evaluations may be made with the assurance that the basic premises for such determination are present.

With the rapidly increasing importance of third party agencies in the financial affairs of the hospital, uniform accounting is most important in assuring an equitable reimbursement for care. This conclusion is true for all parties concerned: namely, the patient, the hospital, and the third party agency.

All hospitals in Canada are compelled by law to submit an annual financial and statistical return to the Dominion Bureau of Statistics. In certain of the Provinces these annual returns are completed by the provincial department of health. In such instances the individual hospitals have been required to make a provincial return which includes the statistical facts required by the Dominion Bureau of Statistics. Since the return required by the Dominion Bureau of Statistics includes detailed financial statements (balance sheet, operating statements and supporting financial schedules) as-

sembled in a prescribed manner, the need for uniform accounting is self-evident.

The Dominion Bureau of Statistics is a fact-gathering organization only. It does not attempt to interpret the data which is collected. Because of this fact, the Bureau has consulted the hospitals as to the development of the type of return which should be made to provide the data essential for the evaluation of hospital activity. The annual financial and statistical returns to be submitted for 1952 and thereafter have been developed with the understanding that the type of uniform accounting referred to here will be in effect in the hospitals concerned. Thus, Canadian hospitals have a real interest in uniform accounting so that they may readily and properly prepare the annual reports demanded by law.

Application of Uniform Accounting

The uniform accounting advocated is one which has evolved logically and naturally. Basically the hospital must use in a consistent manner generally accepted accounting principles. This includes the usual distinction between capital and expense items. Furthermore, accrual accounting in all its aspects is fundamental. To date there has been much discussion as to the propriety of recognizing depreciation as an expense. However, most authorities are now agreed that it should be included in the financial statements of the hospital in the same manner as in industry.

In financial presentations, the operations of the hospital are accounted for by departments. This divisional accounting follows the organizational set-up for general administrative purposes. Departments are distinguished by function and as such may or may not be associated exclusively with a particular locale in the hospital. For instance, the operating room is considered as a department with

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its activity confined to a specific space designated for the purpose of performing operations. On the other hand administration, which is referred to as a department, may not be characterized by the space where the activity is effected. Hospital departments are commonly classified and grouped as to their relationship to one another and to the patient. Those departments concerned with the maintenance of the hospital and where no charge originates for patient care are referred to as "general service departments". In this category are included administration, dietary, house-keeping, laundry, linen, plant operations, maintenance, and motor service. The departments directly related to the rendering of hospital care are referred to as "professional service departments". Departments found in this section are medical and surgical service, nursing service, nursing education, medical records and library, X-Ray, laboratory, operating room, dietary room, pharmacy, and out-patient service. For uniform hospital accounting, accounts are to be maintained for the professional service departments in such manner that the income and expenses for each department may be matched. For these departments it is also desirable to distinguish between in-patient service and out-patient service.

Because hospital expenses resolve themselves for the most part into two major types, salary and wages, and sup-

plies, uniformity calls for a separate account covering each major type in the individual department. It is understood, of course, that further analysis within each of these major categories may be recorded and reported. In fact it is required in the annual return of the Dominion Bureau of Statistics that perquisites be valued and included in salaries and wages. This accounting procedure calls for a financial statement treatment involving a deduction for the valued perquisites from the total determined expenses of the institution. Also the relative importance of medical, surgical, and sterile supplies; and drugs, medicines, and prescriptions are such that a separate recording of each supply group is needed for the completion of the annual return. In addition other expense items not included in these major types are set out separately for the department concerned.

Uniformity is further assured by the use of alphabetical check lists of supplies and a coded chart of general ledger accounts.

A characteristic of uniformity is the requirement that gross earnings be recorded. This is accomplished by using established rates for each type of care and accounting for any deviations. The deductions made from the established care rates are distinguished as to nature and are classified as rebates, courtesy allowances, and charity allowances. It should be noted that bad debt allowances are considered as lost revenue and included in the same account section as deductions allowed.

Uniform hospital accounting is further distinguished by the use of the funded balance sheet. This form of accounting may be attributed to the historical development of the hospital. In the beginning, hospitals as charitable institutions were dependent upon philanthropy for funds. Such funds were more often than not obtained and designated for a

specific purpose such as buildings, equipment, and operating expenses. In order to establish control over such donations, funded accounting was utilized. While philanthropy is becoming relatively less important in the hospitals' affairs, funded accounting can contribute to better control and understanding of hospital finances. Among other things, funded accounting provides for a clear cut distinction in presentation of capital account and operating account resources. For those institutions that possess endowment funds or other designated funds, funding is an accounting "must".

In the uniform accounting suggested for Canadian hospitals, the following funds are considered pertinent:

1. *Revenue Fund* — This fund includes assets and liabilities pertaining to the day to day operation of the hospital. All changes in the fund are presented in the operating statement of the hospital.
2. *Sinking Fund* — Maintained and reported in this fund are the assets required by covenant related to documented indebtedness.
3. *Endowment and Trust Funds* — Funds in this category are those requiring restricted use of the principal. Assets acquired through bequest and subscription are of this nature.
4. *Plant Funds* — Assets, liabilities and capital related to the land, building, and equipment of the hospital are recorded here.

Each of the above funds are self-balancing with the relationship (if any) between funds being maintained by means of "due to" and "due from" accounts.

A suggested chart of general ledger accounts is attached at the end of this article. While this chart of accounts has been adapted from the uniform ac-

counting system recommended by the American Hospital Association, it is such that its use will facilitate the completion of the annual return required by the Dominion Bureau of Statistics in 1952.

Conclusion

Uniform accounting, while relatively new to the hospital, has been advocated for many separate fields of organized endeavour. It has been sponsored for governments, for schools, for churches, for industries, for hotels, for transportation systems, and for associated effort of one kind and other. Thus, the advantages of uniform accounting are universally acknowledged. Canadian hospitals cannot afford to be the exception.

While the uniform hospital accounting discussed here has been limited to general accounting, its sponsors envisage it as the foundation for cost accounting and budgeting.

For those who may be interested in pursuing the subject in detail the following texts are suggested:

1. "The Canadian Hospital Accounting Manual" published by The Canadian Hospital Council (to be released early in 1952) Toronto.
2. "Definitions and Instructions for Completing the Annual Report of Hospitals' Schedules (for 1952)" published by the Dominion Bureau of Statistics — Ottawa.
3. "Handbook on Accounting, Statistics and Business Office Procedures for Hospitals" (Section 1) published by the American Hospital Association — Chicago.
4. "Hospital Accounting Principles and Practice" by T. Leroy Martin, C.P.A., published by Physicians' Record Company, Chicago.
5. "Accounting, Statistics and Business Office Procedures for Hospitals" by Charles G. Roswell, C.P.A., published by United Hospital Fund of New York, New York, N.Y.

6. "Hospital Accounting and Finance" by Geoffrey A. Robinson (Hospital Accountancy under the National Health Services Act 1946 — Great Britain), published by Pitman, London, England.

The hospital in utilizing the extensive managerial features of modern account-

ing will assure itself of the greatest economic use of the resources devoted to better health. Uniform accounting is but one of the accounting means devised to aid administration but, as has been stressed, it is a most important one.

UNIFORM HOSPITAL ACCOUNTING

SUGGESTED CHART OF GENERAL LEDGER ACCOUNTS

REVENUE FUNDS

11. CURRENT ASSETS

- 111 Cash and bank accounts
 - 1111 Cash on hand
 - 1112 Petty cash
 - 1113 Cash in Bank
 - 1114 Cash in Bank
- 112 Accounts receivable — Patients
 - 1121 — Regular patients
 - 1122 — Compensation cases
 - 1123 — Group hospitalization
 - 1124 — Government cases
- 112R Reserve for bad debts
- 113 Notes receivable
- 114 Other accounts and notes receivable
- 115 Supplies and materials — inventories
- 116 Prepaid expenses
- 117 Other current assets

12. CURRENT LIABILITIES

- 121 Accounts payable
- 122 Notes payable
- 123 Salaries and wages payable
- 124 Other current liabilities
- 125 Accrued expenses
- 126 Due to or from other funds
- 127 Working capital

ENDOWMENT AND TRUST FUNDS

13. ASSETS

- 131 Cash in hand (banks or trustees)
- 132 Investments (Bonds, stocks and other securities)
- 133 Real estate — held as investment
- 134 Other investments

14. PRINCIPAL AND LIABILITY ACCOUNTS

- 141 Principal of funds for general purposes
- 142 Principal of funds for designated purposes
- 143 Due to or from other funds

PLANT FUNDS

15. ASSETS

- 151 Land
- 152 Buildings

- 152R Reserve for depreciation buildings
- 153 Permanent equipment
- 153R Reserve for depreciation equipment
- 154 Equipment
- 155 Cash in hand — redemption of bonds or mortgages, etc.
- 156 Building and equipment funds
- 16. PLANT CAPITAL, RESERVES AND LIABILITIES
 - 161 Plant capital
 - 162 Bonds outstanding
 - 163 Mortgages outstanding
 - 164 Accounts payable
 - 165 Notes payable
 - 166 Due to or from other funds
- 17. INCOME AND EXPENSE SUMMARY
 - INCOME (REVENUE FUND)
- 18. GROSS EARNINGS FROM HOSPITAL SERVICES
 - 181 Day rate services
 - 1811 Private rooms
 - 1812 Semi-private rooms
 - 1813 Standard wards
 - 182 Special professional services
 - 1821 In patients
 - 1822 Out patients
 - 183 Operating room
 - 1831 In patients
 - 1832 Out patients
 - 184 Delivery room
 - 1841 In patients
 - 1842 Out patients
 - 185 Nursery
 - 186 X-Ray service
 - 1861 In patients
 - 1862 Out patients
 - 187 Laboratory
 - 1871 In patients
 - 1872 Out patients
 - 188 Other special services
 - 1881 Drugs and dressings
 - 1882
 - 189 Miscellaneous
- 19. DEDUCTIONS FROM GROSS INCOME
 - 191 Rebates
 - 192 Courtesy allowances
 - 193 Charity allowances
 - 194 Bad debt allowance
- 20. OTHER OPERATING INCOME
 - 201 Provincial government grants
 - 2011 Per diem grants
 - 2012 Other grants
 - 202 Municipal grants
 - 2021 Per diem grants

2022	Other grants
203	Hospital care plan grants
2031	Provincial
2032	Other
204	Voluntary contributions
2041	Contributions (Community Chests, special funds, etc.)
2042	Miscellaneous contributions and donations
205	Donated commodities
206	Endowment fund income
207	Miscellaneous income from non-hospital services
208	Sundry income

EXPENDITURE (REVENUE FUND)*General Service Departments*21. **ADMINISTRATION**

211	Salaries
212	Supplies
213	Miscellaneous

22. **DIETARY**

221	Salaries
222	Supplies
223	Miscellaneous
224	Food

23. **HOUSEKEEPING**

231	Salaries
232	Supplies
233	Miscellaneous

24. (1-2-3) **LAUNDRY AND LINEN**25. **PLANT OPERATIONS**26. **MAINTENANCE AND REPAIRS**27. **MOTOR SERVICE***Professional Service Departments*30. **MEDICAL AND SURGICAL SERVICE**31. **NURSING SERVICE AND EDUCATION**32. **MEDICAL RECORDS AND LIBRARY**33. **SOCIAL SERVICES**34. **X-RAY DEPARTMENT**35. **LABORATORY DEPARTMENT**36. **OPERATING AND DELIVERY ROOM**37. **PHARMACY**38. **OTHER SPECIAL PROFESSIONAL SERVICES**39. **GENERAL OUT PATIENT SERVICE**40. **OTHER OPERATING EXPENSES**

401	Depreciation allowance — buildings
402	Depreciation allowance — equipment — (by department where possible)
403	Interest (bank and short loans)
404	Interest (bonds and mortgages)
405	Rent — land and buildings
406	Taxes
407	Miscellaneous expenses — non-hospital service

NOTE: Any of the above accounts may be further sub-divided and indexed by adding a numerical suffix 1, 2, 3.

The Application of Commercial Practices In Determining Taxable Income

By R. W. Manning, C.A.

An accountant questions some of the "accounting" concepts of the Income Tax Act

ONE of the several important advantages to the tax-paying public in the establishment of the Income Tax Appeal Board is the greater opportunity to learn more about the official attitude toward the many ambiguities in the statutes. This advantage is of course more readily apparent to the practitioner in taxation, whose formal contact with such matters was hitherto limited to those encountered in his own professional practice, the exchange of experiences with his colleagues, and the comparatively few represented in disputes carried to the Exchequer Court.

The "poor man's court", however, has already, in about two years of activity, considered over 300 appeals, and here is the means of studying, as stated before, the "official" view, first of the Minister of National Revenue, and second of the Appeal Board, on sections of the Act the correct interpretation of which is not automatic. Here I shall discuss only one type of dispute, that involving the deductibility from income of certain disbursements; and about 20% of the appeals reaching the Board are on this question. Most of them arise under the sections referring to expenses

necessary to earn income and to capital outlays, which are as follows: *The Income War Tax Act* (s. 6(1)) provides that the following shall not be deductible:

- (a) disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income;
- (b) any outlay, loss or replacement of capital or any payment on account of capital or any depreciation, depletion or obsolescence, except as otherwise provided in this Act.

The corresponding provision of the *Income Tax Act* (s. 12(1)) prohibits deductions in respect of

- (a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer;
- (b) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part.

Lest we incur the denunciation of

those who formulate our tax policies, let us admit that the Minister isn't too concerned with whether his interpretation of taxable income conforms to sound accounting principles or standard commercial practice. For a brief period in 1947 and 1948 there was hope that the business man would in future be taxed on profits determined along such lines, but the hope died when the section requiring that income from a business or property "shall be determined in accordance with generally accepted accounting principles" was removed from Bill 454, which, after many amendments, became the new *Income Tax Act*. The result is that in practice many types of disbursements are being disallowed as deductions from taxable income, because (1) they are said to create a lasting benefit, or (2) they are not "wholly, exclusively and necessarily" laid out to earn income, or (3) they are capital rather than revenue payments, or (4) they were made before operations commenced and not in the process of earning income, or (5) they were made to protect a capital investment. These grounds of disallowance will be later discussed separately.

A brief résumé of some of the reported cases is presented for illustration purposes. There is the well-known case of the barrister who hoped to deduct his fee for admission to the Bar of another Province which was disallowed. The cost to a farmer of brushing and breaking land was disallowed, as were the moving costs of a company which moved its business from Montreal to Winnipeg. A chartered accountant was surprised when he was disallowed deduction of payment made for the goodwill, files and working papers of a colleague's practice which he purchased. The travelling expenses of a hockey coach, of a farmer, of a would-be steamship agent, of a professional musician, were not recognized. A firm that did not have enough sugar for its Seven-

up was not allowed the cost of obtaining extra ration allotments. A company went to some expense to cancel the licence it had given another to manufacture its ginger ale, with the same result. Legal costs to enable a tenant to determine his rights under a lease, and those of another to determine his rights under an option, were disallowed. Medical men who take special studies and post-graduate courses will be in for disappointment if they hope to deduct such costs from income according to the decisions. A similar fate is in store for any employer who might be talked into letting his staff entertain at the firm's expense prospective customers at the local golf club. Two taxpayers spent money in the way of architect's fees to determine the feasibility of adding to their real estate holdings, but both were denied any form of deduction because the projects were abandoned. And let us not forget our colleague Mr. I, the chartered accountant, who was not permitted to deduct legitimate expenses from his share of partnership income because he paid them out of his own pocket.

In adjudicating on these several appeals the Appeal Board has sometimes used one case as a precedent for another. It is contended that, as these precedents are developed, they come to be more and more accepted as a matter of course, and the question of whether or not the underlying principles are correct may soon be forgotten. Perhaps it need not be added that this is a dangerous situation, and one of concern to ourselves as practitioners.

It was stated earlier that the grounds stated for the disallowance of disbursements often fall within the five categories listed above.

1. The Creation of a Lasting Benefit

This expression is, I believe, a new

one in the annals of accounting terminology and practice, and therefore it may not be out of place to examine its aspects. The prohibitory sections quoted earlier contain no phrase similar to this; and certainly if a lasting advantage were indeed created, it implies that the disbursement was necessarily laid out to earn the income. So it remains to consider whether such expenditures are in the nature of capital outlays. Everyone, of course, has his own meaning of a capital expenditure, but in applying the test to a particular disbursement, it seems that it is a matter of degree instead of kind. For example, a certain piece of machinery may have the appearance of permanency and thus seem a capital asset, but if it is worn out in a year or two in the process of producing goods, its purchase created no enduring benefit. Thus, the accountant who spends his hard-earned money to buy an established practice finds he has created no lasting benefit for himself, for it is only by his own diligence that he can hope to retain his clients, and if he does the goodwill he has is what he built up himself, not what he purchased. What his money bought him was the right to use the client's files and working papers, an expense necessary to earn income. The doctor who spends money for special studies has not received a lasting advantage, for subsequent research may render the knowledge he gained useless and obsolete; nevertheless the money was spent in the hope of earning income as a result. Even the lawyer who paid an admission fee to the Bar did not purchase a capital asset, which can be sold to someone else or returned if not satisfactory; he may have created a lasting benefit, but his money was spent wholly for the purpose of earning income. So we summarize by submitting that all lasting benefits are not capital assets, that some benefits that appear to be lasting are not so on closer

A partner in the firm of H. R. Doane & Co., Charlottetown, Mr. R. W. Manning, C.A. is a past president of the P.E.I. Institute. He has been chairman of the C.I.C.A.'s Advisory Committee on Uniform Regulatory Legislation and is now on the Board of Governors of the Canadian Tax Foundation.

scrutiny, and that in any event such expenditures are only made when there is a hope of making a profit from them.

2. The Purpose of Making an Expenditure

The description of an expense as "wholly, exclusively and necessarily" laid out to earn income in the *Income War Tax Act* has been modified in its successor to an expense incurred for the purpose of producing income. There seems to be no significant change in intent, and the new section is apparently just as restrictive as the old. There is no complaint with the restriction in itself, but in its application. One does not have to be in business long before he discovers that no expenditure of money is made unless it is in the hope of making a return on the outlay. This applies as much to the payment of employees' golf club dues as to the monthly rent; as much to the cost of the professional musician's tuxedo as to an employee's salary. If such expenditures reduce the tax on profits, so much the better, but tax avoidance is not uppermost in the businessman's mind when he considers such outlays; it is the expectation of making a profit. And a tax on profits is not a tax on profits if it taxes the receipts before deducting the expense. Thus it is contended that all legitimate business expenses are properly deductible from income, and should not be prohibited under this troublesome section

of the Act (unless of course they are personal expenses, and not business expenses at all.)

3. The Distinction between Capital and Revenue Disbursements

Here we cannot be too critical of our worthy adjudicators on the Appeal Board, because if a payment is definitely of a capital nature, there is no choice but to disallow it under the Act as it now stands. Our complaint must be with the legislators themselves, who permit no deduction whatever of capital payments except depreciation and depletion. But after all, what is capital except revenue spread over a period of time? And as in the case of depreciation, why should not all types of capital expenditures be amortized? If they meet the test of being made for the purpose of producing income surely they should be deductible from income, and if they are important enough to produce income over a period of years, the cost should be spread over the same period. If the cost to a farmer of breaking land is indeed a capital expense, it is also an outlay made in the hope of gain and should be amortized against a few years' revenue. If it were recognized in the *Income Tax Act* that capital payments other than for fixed assets should also be subject to annual write-offs, the question of what is capital and what is expense would not matter so much; and Mr. Taxpayer could claim a deduction, if not all in one year, at least over a period — as long as the expense was actually incurred to produce income. This would apply to many of the cases mentioned earlier that have been considered in the Appeal Board and decided against the appellant taxpayer. In such cases as, for example, the purchase of goodwill, it is sound commercial practice to amortize the cost over a period of years; possibly our profession has been slow to bring this to the attention of our lawmakers.

4. Expenditures prior to the Earnings Period

In quite a number of cases where disbursements were disallowed, the Appeal Board relied on a 1940 case involving *The Dominion Natural Gas Co.*, where the following principle was approved: "In order to fall within the category of disbursements or expenses wholly, exclusively and necessarily laid out or expended for the purpose of earning the income, expenses must, I think, be 'working expenses': that is to say, expenses incurred in the process of earning the income." This rule was applied in another case involving the cost of moving a business to another city and it seems to me that that principle should be confined to disallowing the deduction of disbursements made anterior to the actual exercise of a trade or profession. I believe that we should resist attempts to rule out such expenses under IWTA s. 6(1) (a) and ITA s. 12(1) (a). The very essence of incurring costs to get set up in business is the expectation that such costs will eventually pay off in profits. It might be added further that of all expenses, these are the ones that are most necessarily laid out to earn income. The fact that the expenditure is antecedent to the operating period is irrelevant. Many expenses commonly recognized as deductible are incurred before they can produce a return, such as advertising, the purchase of operating supplies, and even merchandise; the familiar mechanics of setting up and amortizing deferred charges provides a ready means of matching expense against income.

5. Expenses to Protect a Capital Asset

There remains still one other reason frequently given for disallowing an expense, that it was made, not to earn income, but to protect a capital investment. This reasoning was applied in a case involving a fee paid to an investment counsel for guidance in selecting

securities, an architect's fee when planning to add an extension to a building, and several involving legal expenses to determine rights. Is it possible that such expenses were disallowed, not because they were to protect capital, and thus income, but because they were unusual in character? Take the simple example of a fire insurance premium for a policy on real estate. It is paid to protect capital and nothing else, but because it is a normal cost encountered in all business, commercial expediency deems it a deductible expense.

In conclusion, perhaps it is not too illogical to contend:

1. The application of accepted accounting and commercial practices should receive more consideration in our income tax laws.

2. It should be recognized that all true business expenses are in fact incurred for the purpose of producing a profit and for no other purpose, and if this is not acknowledged, it is re-

ceipts and not income that will be taxed.

3. If expenses such as we have been discussing are too large or too extraordinary to be applied against the income of one period, they can be amortized over a number of fiscal periods by a simple accounting routine.

4. It is unlikely that such procedures would drain away huge sums from the federal Treasury, but would on the other hand remove a common cause of annoyance to the taxpayer, and an administrative burden and expense to the authorities.

To close with a moral, we cannot lay all the responsibilities on the courts, which interpret the laws, the departments which administer them, the legislators who make them, or the apathetic and long-suffering public for whom they are made. If we hold ourselves out as champions of the public interest, we have a responsibility for the wrongs of the past, and a duty to amend them for the future.

Controlling Contributions to The Manitoba Flood Relief Fund

By O. F. Thorsteinson, C.A.

The system of record and control set up
to handle one of the greatest relief funds in history

AT ITS inception no one could guess that the Manitoba Flood Relief Fund would exceed any other comparable fund in the history of Canada. The time was one of crisis. The Red River was still rising at Winnipeg; the sound of pumps was something you slept with; radios were always on waiting for the latest reports on the river level. But that has been described many times.

The fund's main problem lay in setting up a system of record and control which could expand to any size and yet never be cumbersome. The system finally adopted proved quite workable and effected a strong internal control in the receipt of all moneys.

Arrangements were made by the Management Committee to have all mail delivered to the Manitoba Flood Relief Fund's headquarters twice a day at specified times: 8 a.m. and 3 p.m. Two representatives of the Treasury office, with one representative of the Administration office, took over all deliveries. The mail was opened by machine, the enclosures withdrawn, and envelope and all enclosures were stapled together. At this time only a brief scrutiny was made of the contents. Where no money was

enclosed, the fact was noted and initialled by two of the attendants.

The opened mail containing contributions was taken to the Treasury office in joint custody. In the cash office of the Treasury Department, lots of 50 to 100 pieces of mail were placed in large numbered envelopes, the numbers being controlled by a number card. The envelopes were then turned over to teams of controllers, two to a team.

The lead man of a controlling team removed the contents from the numbered envelope. After checking the amounts of the remittance against the letter and inserting the amount where necessary, he would call the amount to the other member of the team who recorded it on an adding machine tape. Each cheque was recorded separately. Sub-totals were taken after each type of remittance, such as: Canadian cheques, U.S. cheques, Canadian cash, U.S. cash, etc. On completion of the tape, the contributions and the adding machine tape changed hands within the team and the amounts were checked back. Both members of the team initialled the tape which was marked with the envelope number and the date. The information

was transcribed to the face of the numbered envelope and the contents were replaced. The completed tape was handed to the comptroller who recorded the total in his control ledger.

The envelope was then handed to a "splitter", who separated cheques and cash from the other enclosures and envelopes. Each letter was scrutinized and the name and address circled in red pencil. The amount noted was rechecked to the remittance. All cheques were noted on the back with the envelope number, stamped for deposit, and listed on an adding machine tape for deposit purposes. Cash was counted and listed in detail. This deposit information was listed on the face of a deposit envelope in which all cash and cheques were sealed. The total was checked against the information envelope and, if correct, handed to the cashier for deposit. The information envelope was passed to the listing department.

The listing department controlled all envelopes passed to them. A typist was assigned to listing the names of all contributors, with addresses and amounts. Six copies of the list were prepared for the various committees. On completion, the lists were checked by a team, added and balanced to the total requirements of the information envelope. One copy was stamped with an identification mark of the Treasury Department.

The Treasury Department list was handed to a typist who issued receipts. These receipts were prepared in triplicate in strips of five hundred with carbon inserts. On completion of the typing, the receipts were checked by a team which recorded the number against each contribution on the list. Receipts had been designed for insertion in window envelopes, so that no further typing was required.

The duplicate receipts were filed alphabetically, and the triplicates were

After five years in the R.C.A.F. during the war, Mr. O. F. Thorsteinson, C.A. joined the firm of Dunwoody, Saul, Smith & Co., Fort Frances, Ont., and was admitted to the Manitoba Institute in 1948. From 1948 to 1951 he was chief auditor of the City of Winnipeg, during which time he was responsible for the handling of the Manitoba Flood Relief Fund. He is now office manager of Canadian Motors Ltd. at Brandon, Man.

Mr. Thorsteinson acknowledges his indebtedness to Messrs. V. Driver, C.A., S. G. Barber, and F. L. Crease, all of the Audit Department of the City of Winnipeg, for their assistance in the setting up of the system described and in the preparation of the article.

filed numerically. This system proved most valuable in tracing enquiries, requests for duplicates, etc.

380,000 Receipts!

The whole routine required a large staff to handle it, owing to the tremendous volume of remittances. Approximately 380,000 receipts have been issued from the central office. The amount of checking done has proved most effective in eliminating errors and has simplified the otherwise difficult task of answering inquiries.

Interim receipts were issued by the "splitters" to companies and collection agencies who stated their intention of forwarding lists of the individual contributors for receipts. The number of the interim receipt was noted prominently on the letter and was typed on the list in the receipt column.

Such lists of individual contributors were placed in numbered information envelopes, marked "No Control Tape". On the face of the envelope were listed

the name of the company and the total amount of the list against which the interim receipts were listed and balanced. Usually, several such lists were placed in one envelope. The control number was recorded in the control ledger with the words "No Control Tape".

The identification of each cheque with a list by numbering on the back proved a real help in tracing contributions, particularly in respect to returned cheques.

Premiums on U.S. cheques were credited by the bank to a special account. This arrangement made it unnecessary to compute the amount on the control tapes. Such remittances were listed and receipted with the letters "U.S." after the amount. Premium on cash was computed on the deposit slip and recorded in the control ledger from this source.

The control ledger on contributions consisted of a two-column ledger. A combination "contribution credit" and "cash debit" column and a combination "cash credit" and "bank debit" column were found adequate. Disbursements were entered in "bank debit" and "bank credit" columns, but there would have been a saving in analytical work had a multi-columned synoptic journal been used for this portion of the work.

This system has proved excellent throughout the life of the fund. The fund expanded to handle \$6,000,000 in six weeks with eight to twelve men handling the cash, and contracted to one list a week which one man could handle in a few minutes, though losing, of course, the joint custody feature of the active fund.

A Letter from a Reader

London, Dec. 3, 1951

SERVICE UNDER ARTICLES

Sir: I have read the address of Mr. D. R. Lukin Johnston, C.A. to the 49th annual meeting (from which, most regretfully, I was compelled to be absent) with more than usual interest, as it deals with a subject in which I have been vitally concerned both as a principal and a parent. In connection with it, my son's whole future as a chartered accountant has been altered.

Mr. Johnston, unfortunately, did not deal with a fundamental aspect of service under articles which our predecessors fully understood and carried out, but which we choose or, through economic stringency, are coming to ignore. Service under articles is not, never was, and never can be (if the profession is to maintain anything like the status that our honoured forbears set up) "employment". It is a period of higher education, equivalent to time spent at a University, taken immediately after leaving school and is merely part of the ascending scale of education which

starts in the nursery and comes to a climax when the child is fully equipped to face the business world with his final examination certificate safely secured. To deal with it in any other way, or to call it anything else, especially "employment", is to start both the article clerk and the principal off "on the wrong foot". The clerk forgets what he is there for, and instinctively compares his lot with that of his school-fellows who have gone into other spheres and the principal, unless he is the one hero left, looks upon the clerk's education as a "chore", or, worse still, as has happened in my own experience, as cheap labour.

The day of the big premiums is gone, I know, but, if only to make the clerk realise that money has been spent on his higher education and to put the principal under monetary, as well as moral, obligation to the clerk, a nominal premium must be maintained. In addition, the "small salary", be it the \$40 to which Mr. Johnston refers or the famous £1 a week here, should never be

called "salary" (but — e.g. "allowance"), because if it is, then that is what the clerk thinks he is earning without comprehending all the benefits which he is getting out of his principal's hard won experience.

The future of our profession lies in the word "craftsmanship", and to acquire a craft means a long period of hard, unremunerated work. Our boys, despite all the modern dis-

tractions, are still first-class and if the matter is put clearly and straight-forwardly before them right at the outset, they will answer the call to higher realms. But deter them, and confuse them, with all this talk about salaries, employment etc. and they will not come forward, just as Mr. Johnston laments.

LLEWELYN H. WRIGLEY, C.A.

Professional Notes

ASSISTANT SECRETARY ADDRESSES WESTERN INSTITUTES

Mr. Melville Pierce, B.A., LL.B., assistant secretary of the C.I.C.A. and editor of *The Canadian Chartered Accountant* and *The Tax Review*, visited Vancouver, Edmonton, Winnipeg, and Regina in late November and early December, and delivered an address on "The Taxation of Income and Capital Gains in Canada." The Vancouver meeting on November 29, which was the semi-annual session of the B.C. Institute, also heard a technical paper by Mr. Alex. Reid, C.A. Mr. J. E. McIntosh, president of the B.C. Institute, presided, and Professor J. M. Moynes, C.A., chairman of the technical education committee, introduced the speakers. The meeting of the Edmonton Chartered Accountants Club, under the presidency of Mr. R. D. Purvis, C.A., took place at the Edmonton Club on Monday, December 3. At this meeting the new secretary of the Alberta Institute, Mr. A. D. McTavish, C.A., was introduced by Mr. J. M. Tweddle, C.A. Following the Edmonton meeting, Mr. Pierce addressed a large gathering at the Fort Garry Hotel in Winnipeg, which included many members of the legal profession who had been specially invited. His Honour Mr. R. F. McWilliams, K.C., Lieut.-Governor of Manitoba, occupied the seat of honour at this meeting. Mr. William Young, C.A., president of the Institute, presided, and the speaker was introduced by the vice-president of the Institute, Mr. Daniel Sprague, C.A. The next day the Regina Chartered Accountants Club heard Mr. Pierce, who arrived by train late in the evening, all plane flights having been cancelled

owing to bad weather. The Regina meeting was held at the Assiniboia Club under the chairmanship of Mr. Walter Read, C.A. Mr. Harold S. Moffet, C.A., president of the Saskatchewan Institute, moved the vote of thanks to the speaker.

BRITISH COLUMBIA

Mr. W. D. Osborne, C.A. announces the admission to partnership of Mr. Lyle V. Flury, C.A. Practice of the profession will be conducted under the firm name of Osborne & Flury, Chartered Accountants, with offices at 601-604 Bank of Toronto Bldg., Victoria.

* * *

Mr. Richard D. Peers, C.A. announces the opening of an office for the practice of his profession in the Bank of Nova Scotia Bldg., 675 Davie St., Vancouver.

* * *

Alexander Kennedy Miller & Co., Chartered Accountants, announce the opening of an office at 412 Seymour St., Vancouver, with Mr. S. E. Stanford, B.Com., C.A. as resident partner.

* * *

Winspear, Hamilton, Anderson & Co., Chartered Accountants, announce the removal of their Vancouver office to their new building at 1505 Robson St., Vancouver.

NEW BRUNSWICK

A meeting of the New Brunswick Institute of Chartered Accountants Students Society, Moncton Branch, was held in the offices of Hudson, McMackin & Co. on November 24. The guest speaker was Mr. G. W. Hudson,

C.A. who spoke on "Capital Cost Allowance as Related to Income Tax and Accounting Principles". He was introduced by Gary Whalen and thanked by Bernard Bonnar. George Steeves, chairman, presided.

ONTARIO

Mr. John Funk, C.A. announces the opening of an office for the practice of his profession at 60 St. Paul St., St. Catharines.

Chartered Accountants Club of Ottawa

The November luncheon meeting of the Chartered Accountants Club of Ottawa had as the guest speaker Mr. R. B. Graham of the Aluminum Company of Canada Ltd. who spoke on Alcan of B.C.'s development plans.

At the December luncheon meeting the speaker was Dr. J. R. Petrie, director of research for the Canadian Tax Foundation, who spoke on "Taxation and Inflation".

The recently elected officers and executive for the 1951-52 season are as follows: *president*, H. T. Aitken; *vice-president*, C. G. Gale; *secretary*, W. G. Baden Read; *treasurer*, G. F. Wevill; *members of executive committee*, W. H. Buck, B. A. Millar, L. Masse, J. H. Laird.

Messrs. Thornton, Milne & Campbell, Chartered Accountants, Winnipeg, announce the opening of a branch office for the practice of their profession at 32 Royal Bank Bldg., Bloor and Yonge Sts., Toronto. This office will be under the management of Mr. T. J. Batchelor, C.A.

George A. Touche & Co., Chartered Accountants, announce the opening of an office for the practice of their profession at 267 Dundas St., London, with Mr. Ralph C. Cowle, B.Com., C.A. as resident partner.

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Mr. F. Martin Turnbull, C.A. announces the opening of an office for the practice of his profession in the Shaver Bldg., 68 Main St., Huntsville.

QUEBEC

Messrs. L. Henry Benjamin, C.A., L. David Small, C.A., and Sydney I. Benjamin, C.A., partners in the former firm of Arbes, Benjamin, Small & Co., Chartered Accountants, announce that they are continuing their association under the firm name of Benjamin, Small & Co., Chartered Accountants, with offices at Ste. 337, University Tower, 660 St. Catherine St. W., Montreal.

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Vineberg, Raphael, Goldstein & Co., Chartered Accountants, announce the removal of their offices to 2024 Peel St., Montreal.

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Mr. Harold Alper, C.A. announces the opening of an office for the practice of his profession at Ste. 28, British Empire Bldg., 204 Notre Dame St. W., Montreal.

SASKATCHEWAN

Hesford, Wik, Jeffery & Stark, Chartered Accountants, announce the removal of their offices to the Standard Motors Bldg., Swift Current.

News of Our Members

Mr. A. F. D. Campbell, C.A. (Man.), has been appointed a vice-president of Stafford Foods Limited and Stafford Metal Industries Limited.

* * *

Mr. Harold A. Agar, C.A. (Ont.), has been appointed as comptroller of Gair Company Canada Limited, Toronto.

* * *

Mr. Gordon T. Wishart, C.A. (Ont.), has

been appointed a director and vice-president of Metals and Alloys Limited.

* * *

The December issue of *The Internal Auditor* contains three articles by chartered accountants: "How Can the Internal Auditor Assist the External Auditor in Carrying Out the Annual Stockholders' Audit?", by J. A. Wilson, F.C.A. (Ont.); "The Role of the Internal Auditor in Canadian Oil Compan-

ies, Ltd.", by W. H. Rea, C.A. (Ont.); and "Internal Audit of Control Systems", by T. F. Griffin, C.A. (B.C.)

* * *

Mr. S. A. Kerr, B.Com., C.A. (Que.), A.C.I.S., has been appointed secretary of Dominion Tar & Chemical Co. Ltd., Montreal.

Obituaries

Alexander Fraser Moffatt

The Institute of Chartered Accountants of Saskatchewan announces with deep regret the death of Alexander Fraser Moffatt in his 43rd year following a lengthy illness.

Born in North Sydney, N.S., Mr. Moffatt was a graduate of the University of Saskatchewan and was admitted to the Saskatchewan Institute in 1933. For six years he practised the profession in Indian Head and Prince Albert, Sask. In 1939 he came to Ottawa and until ill health forced him to relinquish his duties, he was treasurer of the Ottawa Civic Hospital.

Mr. Moffatt was a director of the Ontario Hospital Association and was second vice-president of the American Hospital Association.

To his widow and family the members of the Institute offer their sincere sympathy in their bereavement.

Frederick Benwell Griffin

The Institute of Chartered Accountants of British Columbia announces with deep regret the death of Frederick Benwell Griffin in his 71st year.

Born in Ely, England and coming to Vancouver in 1908, Mr. Griffin was articled to the firm of Price, Waterhouse & Co. and was admitted to the Institute in 1924. Subsequently, he was comptroller of Campbell River Mills Ltd. at White Rock, B.C., and later, while associated with the Dominion Income Tax Department, moved to Victoria, B.C., to take charge of the divisional office there. He retired from this position in 1945, and a year later opened an office in that city for the practice of his profession.

Mr. Griffin was for a number of years Dean's Warden at Christ Church Cathedral in

Three chartered accountants are serving as officers of the Montreal Chapter of the Institute of Internal Auditors. They are as follows: *president*, Mr. T. H. Lett, C.A. (Ont.); *vice-presidents*, Mr. Paul N. Boulton, C.A. (Ont.); *governor*, Mr. E. G. Aust, C.A. (Que.).

Victoria, and took an active interest in the affairs of that diocese.

To his daughters and sons, one of whom, Thomas F. is a member of this Institute, the members extend their sincere sympathy.

C. J. Pitt

The New Brunswick Institute of Chartered Accountants announces with deep regret the death of Mr. C. J. Pitt in Montreal.

Mr. Pitt was admitted to the New Brunswick Institute in 1920 and for many years was associated with the Excise Division of the Department of National Revenue in Montreal.

To his family the members of the Institute extend their sincerest sympathy.

Carl Frank Paul Flaman

The Institute of Chartered Accountants of Ontario announces with regret that Carl Frank Paul Flaman was killed in a highway traffic accident on November 26, 1951, at the age of 34. Just a few days prior to the accident, he had been an unsuccessful Liberal candidate in Peel County during the provincial elections. A graduate in Accounting from the University of Saskatchewan, Mr. Flaman first became a student of the Quebec Institute and came to Ontario after passing the intermediate examination. He was a prize-winner when he passed the final examinations in 1945. Since 1948, he was general manager of Huddleston Motors in Toronto, until quite recently, when he established an office in Brampton for the practice of his profession.

To his wife and four children the members of the Institute extend their sincerest sympathy.

The Students' Department

J. E. Smyth, C.A., Editor

NOTES AND COMMENTS

HAVING a typical North American sympathy for the underdog (whether the underdog deserves it or not) we applaud every time the statement of source and application of funds presents itself. But we sense that it may not be entirely the merits of the statement (at least as presently prepared) that explain its under-dogged persistence. Instead, the explanation of the increasing popularity of the statement may lie in part at least in a growing consciousness that all that goes on in business cannot be described adequately within the framework of the balance sheet and income statement.

In a University of Illinois Bulletin¹ Professor R. K. Mautz expresses the view that "the funds statement does not appear to be a soundly conceived accounting report". He gives the following reasons for his opinion:

1. "The expression 'funds' has no precise significance."
2. The statement "attempts to balance funds provided within the period against funds applied. As a matter of fact there is no necessary equality of these two, because funds applied in one period could very well be funds provided in previous periods."
3. The practice of adding depreciation

back to the net income figure "gives a very strong implication that funds are provided by depreciation".

4. "The customary procedure of preparing a funds statement from comparative balance sheets can easily result in omitting important financial transactions. An identical balance in the notes payable account at the beginning and end of the year would not affect the change in working capital over the year and therefore would not appear in the statement although borrowing of a considerable amount might have been made and repaid during the year."

* * *

Out of our sense of obligation to stand up for an underdog under attack we submit, with respect, that the above criticisms apply to the statement *as customarily prepared*. We are not convinced that if one really took the preparation of the statement seriously he could not meet these criticisms. Suppose we consider them in turn.

We interpret the word "funds" to be synonymous with "working capital". If this is so, then the statement should be called instead a statement of source and application of working capital. If any doubt exists about the definition of working capital in a particular instance the statement can be supplemented by another, showing in detail the change in the composition of working capital over the year.

¹R. K. Mautz, "An Accounting Technique for Reporting Financial Transactions", Bulletin No. 7, University of Illinois, July 1951.

The second criticism, we submit, might be met by changing the customary form of the statement. Could one not start with a figure for working capital at the beginning of the year, add sources, deduct applications, and come to a figure for working capital at the end of the year?

We agree that the form of "funds statement" in which provision for depreciation appears as a positive item among the sources of working capital is not satisfactory. Clearly, recorded depreciation has not been a source of working capital. It is instead an expense that is unusual for the fact it has not reduced working capital. But the difficulty can be resolved by breaking the figure for income into its components and showing sales revenue as a source of funds and the various expenses (other than depreciation) as applications of working capital.

SOLUTION TO THE JANUARY PUZZLE

Th puzzle is solved by striking out the first figure of the top row, the whole of the second row, and the two first figures of the last row. The sum will then stand as

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*	*	*
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We are also in hearty agreement with the view that the statement should not be prepared from comparative balance sheets. If the statement is prepared for a particular business there is no reason it cannot be prepared from the ledger accounts. Admittedly the statement has in this respect a potential that needs developing. Merely because the balance in an account is little if at all different from what it was at the beginning of the year is no indication that during the year there have not been important sources and applications of working capital related to the item in question. An analysis of the ledger accounts can produce these data for use in the statement. Probably nothing has done so much to discredit the "funds statement" as the practice of referring only to beginning and end of year balances and showing "net changes" in the statement.

A PUZZLE FOR FEBRUARY

The proprietor of a menagerie was asked how many birds and how many beasts it included. He replied: "Well, the lot have 36 heads and 100 feet." How many of each were there?

(FROM: *101 Amusements for All*, by Charles F. Bishop.)

Editor's plea: Have our readers no puzzles to contribute?

CORRESPONDENCE

Ottawa, Canada.

Sir: Anent your comments on page 224 of the November issue about the treatment of cash discounts, you didn't tell us what you would do with your account "Cash discounts not taken".

Speaking from the viewpoint of one who is vitally interested in cash discounts I suggest that the "result" of either method (which is what we are interested in) will be in direct proportion to the supervision

exercised by those who sign the cheques. There is no substitute for this factor.

We handle 4,000 invoices monthly and it is a continual battle to get clerks to watch for invoices which offer cash discounts. Under your system an invoice entered inadvertently in the purchase book as "gross" probably would be paid as gross; so your "cash discounts not taken" would not reflect this omission. I therefore question its value.

In wholesale and retail enterprises cash discounts taken and/or allowed, as with inward and/or outward carrying charges, are important control factors when expressed as percentages of purchases or sales and compared with those of prior years. Such figures frequently have an important bearing on policy decisions and long-term planning.

For example, what would happen if the treasurer took 100% of all cash discounts over a period of years during which the purchasing agent gradually quit bargaining for cash discounts? Your system would not uncover this trend. Or, suppose that 80% of your cash discount comes from terms of "2% 10th prox."? Why treat all those invoices individually if the discount can be taken in one calculation for each supplier?

E. WARDLE

The Editor's Reply

We are not yet convinced that the problem of persuading clerks to watch for invoices that offer cash discounts would be any greater under the system suggested than under that in general use. It seems to us that if clerks cannot be relied upon to watch for this sort of thing, then any method of accounting for cash discounts is as good as another!

On your point about a number of invoices from the same supplier being subject to discount if paid by the tenth of the following month, would it not be true that as these invoices have to be handled individually in many other respects, the additional work of calculating the discount for each might not be very important?

While we have disputed the points already mentioned, we feel we must concede your other point about data on cash discounts taken being used as a control factor. We confess that this had not occurred to us, though possibly because, rightly or wrongly, we had rather come to the conclusion that the offering of cash discounts had generally declined within the past few years.

Rejoinder to the Editor's Reply

Ottawa, Canada

Sir: I assure you that the biggest problem faced by the administrator is to get clerks to look just a little further than the ends of their noses. They cannot "be relied upon" to watch for this sort of thing. I sign cheques for about \$5,000,000 each year, so I have some knowledge of what I am talking about.

Therefore, "any" method of accounting for cash discounts is not "as good as another". The only method which is of use to us is one which enables us to measure the results of this year against the results over a period of years. Discounts lost would be as good a measuring stick as discounts taken if the discounts lost could be accounted for in some manner not dependent on human frailties. No such method is available. Hence my conviction that it is better to deal with facts. Discount taken is a fact. Discount lost would be at best a poor guess.

I might add that cash discounts are very important to the distribution trade and the subject receives a great deal of attention from our associations. Discounts taken provided 18.7% in 1948, 22.3% in 1949, and 14.4% in 1950 of our net income before taxes.

Also, I venture to suggest that this matter points up once again what all of us need to be reminded of from time to time: there are few, if any, absolutes. A method good in one business is not necessarily good in all businesses.

E. WARDLE

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM 1

Final Examination, October 1950

Auditing I, Question 2 (17 marks)

What are the ethical rights and responsibilities, if any, of a chartered accountant under the following unrelated circumstances:

- (a) On undertaking a new audit it is found that the balance sheet at the end of the previous fiscal year bearing the unqualified report of the former auditor is not in accordance with the books and contains several obvious misstatements.
- (b) Although the activities of certain officers of a limited company, of which the chartered accountant is auditor, are properly reflected in the books and in the operating statements, and the financial position is presented in the balance sheet, the auditor has reason to believe that they are criminally culpable.
- (c) A fellow member of the Institute informs him that he has been requested to act as tax consultant to a limited company of which the chartered accountant is the auditor.
- (d) Another firm of chartered accountants approaches one of his employees with an offer of employment, before first approaching the chartered accountant.
- (e) The president of a limited company, incorporated under *The Companies Act, 1934*, informs the chartered accountant that he will have to reduce his fee or relinquish the audit as another firm of chartered accountants has quoted a lower fee.
- (f) The chartered accountant happens to see a copy of a fraternity quarterly in which a fellow member of the Institute has inserted a card describing himself as "income tax consultant" and "systems expert".
- (g) The officers of a limited company, of which the chartered accountant is auditor, are known by him to be using certain confidential information for their own private gain and to the advantage of competitors of the company.
- (h) The chartered accountant is approached by the president of a limited company to act as its auditor for a stated fee.

A SOLUTION

- (a) He should communicate with the former auditor to find out if there is any explanation of the situation before discussing the matter with the client.
If the former auditor is a chartered accountant he should inform the Institute of his findings.
- (b) If the activities are continued the C.A. should disassociate himself from the audit. Since the information he has was presumably secured in the course of the audit work, the C.A. must not disclose it unless required to do so in the courts.
- (c) None. Such an arrangement is proper.
- (d) Upon learning of the action the C.A. may protest to the Institute.
- (e) If the president does not give him the name of the auditor who has quoted a lower fee, the C.A. will have to wait until the time of the company's annual general meeting before he can take any action. Under the Act the auditor is entitled to notice of the intention to elect other auditors and on receipt of such notice he may lodge a complaint with the Institute.
- (f) He should inform the Institute of the circumstances.

- (g) He should demand that they cease such conduct forthwith; if they do not comply he should bring it to the attention of the shareholders.
- (h) He should find out the name of the former auditor, if any, and the circumstances under which he is retiring from the appointment. After such action the C.A. is free to accept the appointment.

PROBLEM 2

Final Examination, October 1950

Auditing II, Question 3 (17 marks)

- (a) Explain briefly the term "Fund Accounting" as it is applied to the accounts of a municipality, indicating why the auditor must concern himself with the proper application of this concept.
- (b) List the audit procedures that should be followed in the verification of revenue from property taxes.

A SOLUTION

- (a) Fund accounting as it is applied to the accounts of a municipality means the segregation or *ear-marking of funds for specific purposes*. Funds raised on trust that they will be used for a specified purpose should be segregated and separate balance sheets or sections of balance sheets prepared for each, e.g., revenue funds, capital funds and sinking funds. Such a segregation will reveal the use of funds for other than specific purposes. It is usually required by provincial law and the auditor should be sure that the accounts are being kept properly.
- (b)
 - (1) Test check town plans to assessment roll to ascertain that all properties are included; or test check building permits issued to assessment roll and test check subdivision plans registered during the year.
 - (2) Test check assessment roll to that of prior years.
 - (3) Add assessment roll.
 - (4) Examine assessor's and clerk's sworn certificates as to the correctness of the assessment total as shown by roll.
 - (5) Check changes in assessment to Court of Revision minutes.
 - (6) Test check assessed values of individual properties from assessment roll to tax roll.
 - (7) Check mill rates to council by-law.
 - (8) Test extensions of individual property assessments, for general taxes and school rates.
 - (9) Check total of tax roll by multiplying total assessment by various rates.
 - (10) Check local improvement levies from local improvement tax rolls to main tax roll.
 - (11) Add tax roll.
 - (12) Post totals of tax roll to taxes receivable and appropriate revenue accounts.

PROBLEM 3

Final Examination, October 1950

Auditing II, Question 4 (11 marks)

The auditor employs both "analytical" and "checking" procedures in the course of his work. Briefly contrast these two procedures, giving examples of each.

A SOLUTION

"Analytical" auditing procedures are those carried out in the study of the nature of the business and various trends as indicated by reference to past operations for the particular business and for the industry as a whole and the appraisal of the motives of management, e.g.,

1. a study of monthly statements and statistical information regarding the industry as a whole;
2. a scrutiny of the general ledger accounts and books of original entry for the year;
3. an examination of the larger transactions in selected accounts (Fixed assets, Repairs, etc.);
4. a study of gross profit percentages;
5. a study of the system of internal control.

"Checking" procedures are the routine audit procedures carried out to establish the accuracy of the books of account, e.g.:

1. checking additions;
2. checking trial balances;
3. vouching;
4. checking postings;
5. verifying bank reconciliations.

PROBLEM 4

Final Examination, October 1950

Auditing II, Question 7 (11 marks)

The C Co. Ltd. has had a complete physical inventory taken at the fiscal year end. List the points the auditor would consider and the methods he would use to satisfy himself as to the accuracy of the inventory "cut-off".

A SOLUTION

In satisfying himself about the accuracy of the inventory cut-off the auditor should consider the following points:

1. Are recorded purchase costs understated? In other words, were any goods received by the year end for which liability has not been set up?
2. Are recorded purchase costs overstated? In other words, has liability been set up for goods not received by the year end?
3. Were there any goods in transit over the year end? If so, how were they treated on the accounts?
4. Is recorded sales revenue understated? In other words, were any goods shipped to customers for which the customers had not been billed by the year end?
5. Is recorded sales revenue overstated? In other words, were any customers billed by the year end for goods not yet shipped to them?

In dealing with the first two points (which question the accuracy of recorded purchase costs) the auditor will compare the receiving reports for the last few days of the fiscal year and first few days of the new year with the purchase vouchers. The auditor will also examine the actual physical inventory sheets to learn whether the particular items mentioned in the receiving reports and purchase vouchers were in fact included in year end inventory. He should see that the necessary adjustments are made where the purchase cost (and corresponding liability) has not been recorded for goods included in inventory, and where purchase cost (and liability) has been recorded for goods not shown in inventory.

The auditor will have the opportunity to ascertain the extent of goods in transit at the year end in his scrutiny of the purchase vouchers of the period following the balance sheet date. On this occasion he should pick out all invoices dated prior to the year end which are of material amount and check them to the receiving book to see that the goods were received subsequent to the year end. If the amount involved is substantial, he should suggest to his client that the goods be included in the inventory as "stock in transit" and the corresponding purchase cost and liability recorded.*

In dealing with the last two points (questioning the accuracy of recorded sales revenue) the auditor will compare the shipping records with the sales record (or with copies of sales invoices) for the last few days of the fiscal year and the first few days of the new year. He should also make a check of the actual physical inventory sheets to ascertain whether any goods invoiced to customers, or whether any goods reported as shipped, are included. If goods allegedly sold are still included in inventory, the auditor has to consider whether the sale was bona fide or a mere fictitious sale designed to inflate recorded revenue. The shipment of goods sold may of course be delayed by special arrangement with the customer; in which case no correction of recorded sales revenue is required and the auditor need only be sure that goods sold are not included in year end inventory. Similarly, if the inventory has actually been reduced by shipments to customers not yet recorded as sales, the auditor has to consider whether sales revenue has been intentionally understated. Again, it may be that the goods shipped were not in fact sold but were shipped on consignment or on approval; in which case no correction of recorded sales revenue is required and the auditor need only be sure that the goods shipped ~~are~~ included in inventory.

*Editor's Note: If, however, goods in transit are not included in year end inventory there will be no distortion of the cost of goods sold or profit figure as long as the corresponding purchase cost and liability are not recorded either. This will be so because the two figures for the cost of merchandise purchases for the year and the cost of year end inventory are each understated by the same amount.

